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BEFORE THE HOUSE ENERGY AND COMMERCE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

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Chairman Stupak and Members of the Subcommittee, I appreciate this opportunity to testify before you today and I thank you for calling this hearing to examine the critically important issue of the need for greater transparency in our energy markets. My name is Laura Campbell and I am the Assistant Manager of Energy Resources for Memphis Light Gas & Water (MLGW). MLGW is the nation's largest three-service municipal utility and currently provides service to more than 420,000 customers. Since 1939, MLGW has met the utility needs of Memphis, Tennessee and Shelby County residents by delivering reliable and affordable electricity, natural gas and water service. Natural gas is the most popular means of residential heating in the MLGW service area and we currently provide natural gas to more than 313,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's members have lost confidence that the prices for natural gas in the futures and the economically linked over-the-counter ("OTC") markets are an accurate reflection of supply and demand conditions for natural gas. This lack of confidence has increased over the past several years as volatility in the natural gas market has drawn hedge funds and others to the market. Restoring our trust in the validity of the pricing in these markets requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other abusive market conduct. APGA strongly believes that this level of transparency currently does not exist, and this has directly led to the current lack of confidence in the natural gas marketplace. Although APGA's number one priority is the safe and reliable delivery of affordable natural gas, which ultimately will require an increase in the supply of natural gas, it is equally critical that public confidence in the pricing of natural gas be restored through increased transparency.

APGA believes that statutory changes are necessary to remedy the lack of market transparency which undermines the public's confidence in the pricing integrity of these markets. Accordingly, APGA has called upon Congress to move quickly to pass legislation that would increase transparency in the natural gas markets.

The Market in Natural Gas Contracts

The market for natural gas financial contracts is composed of a number of segments. Contracts for the future delivery of natural gas are traded on the New York Mercantile Exchange ("NYMEX"), a designated contract market regulated by the Commodity Futures Trading Commission (CFTC). Contracts for natural gas are also traded in the OTC markets. OTC contracts may be traded on multi-lateral electronic trading facilities which are exempt from regulation as exchanges ("exempt commercial markets" or "ECMs"). They may also be traded in direct, bi-lateral transactions between counterparties, through voice brokers or on electronic platforms. OTC contracts may be settled financially or through physical delivery. Financially-settled OTC contracts often are settled based upon NYMEX settlement prices and physically delivered OTC contracts may draw upon the same deliverable supplies as NYMEX contracts, thus economically linking the various financial natural gas market segments, including regulated futures markets, ECMs and bilateral trading, whether conducted on an electronic trading platform or otherwise.

The exemption under Section 2(h) (3) of the Act providing for ECMs was added as part of the Commodity Futures Modernization Act of 2000 ("CFMA"). In general, the greater flexibility of a principles-based regulatory framework provided for by the CFMA has worked exceedingly well with respect to the regulated markets, as has the CFMA's overall concept of tiered regulation based upon the characteristics of the trader and of the commodity traded. However, since enactment of the CFMA, changes in the nature of trading and the composition of traders on ECMs warrant reconsideration of the provisions relating to ECMs. More broadly, as discussed in greater detail below, issues surrounding the lack of transparency are particularly acute with respect to trading in contracts for natural gas and the lack of transparency with respect to the market for natural gas should be reconsidered. In this regard, differentiating the appropriate regulatory response based upon the characteristics of the particular commodity traded is consistent with the overarching framework and philosophy of the CFMA.

Specifically, with respect to ECMs, there is scant legislative or regulatory history with respect to the intent behind the Section 2(h)(3) exemption. Nevertheless, the trading platforms that have qualified for exemption under this provision have evolved since enactment of the CFMA in a number of ways. Initially, such markets tended to be an electronic substitute for voice brokers with respect to the trading of OTC contracts. Their participants were generally limited to those in the trade and trading likely carried with it counterparty credit exposure. Since then, however, ECMs have introduced cleared transactions, effectively removing the counterparty risk of such transactions which initially distinguished their trading from trading on futures exchanges. In addition, ECMs over the years have attracted greater numbers of non-trade market participants, such as hedge funds. The introduction of clearing of contracts that are financially settled based upon the settlement prices of regulated futures contracts along with this broader and deeper non-trade customer base has, over time, rendered trading on some ECMs to be largely indistinguishable from trading on regulated futures markets. These markets are economically linked through arbitrage and the prices on one affect prices on the other.

The economic links between the natural gas futures contracts traded on NYMEX and those contracts, agreements and transactions in natural gas traded in the OTC markets (which include but are not limited only to trading on ECMs) are beyond dispute. Without question, a participant's trading conduct in one venue can affect, and has affected, the price of natural gas contracts in the other. [1]

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies ("LDC"), including APGA members, is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract. Accordingly, the futures market serves as the centralized price discovery mechanism used in pricing these natural gas supply contracts. Generally, futures markets are recognized as providing an efficient and transparent means for discovering commodity prices.[2] However, any failure of the futures price to reflect fundamental supply and demand conditions results in prices for natural gas that are distorted and which do not reflect its true value. This has a direct affect on consumers all over the U.S., who as a result of such price distortions, will not pay a price for the natural gas that

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[1] *See "Excessive Speculation in the Natural Gas Market,"* Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report"). The PSI Report on page 3 concluded that "Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap. . . . The data show that prices on one exchange affect the prices on the other."

[2] *See* the Congressional findings in Section 3 of the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act"). Section 3 of the Act provides that, "The transactions that are subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for . . . discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

reflects bona fide demand and supply conditions. If the futures price is manipulated or distorted, then the price a consumer pays for the fuel needed to heat their home and cook their meals will be similarly manipulated or distorted.

Today, the CFTC has effective oversight of NYMEX, and the CFTC and NYMEX provide a significant level of transparency with respect to NYMEX's price discovery function. But, the OTC markets, which include but are not limited to ECMs, lack such price transparency. The lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in manipulative or other abusive trading strategies with little risk of early detection; and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market. It simply makes no sense to have transparency over one segment of the market and none over a much larger segment, especially when the OTC markets are the fastest growing sectors of the natural gas marketplace. APGA strongly believes that it is in the best interest of consumers for Congress to rectify this situation by passing legislation that would ensure an adequate level of transparency with respect to OTC contracts, agreements and transactions in natural gas.

Regulatory Oversight

NYMEX, as a designated contract market, is subject to oversight by the CFTC. The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on NYMEX. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/non-commercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the NYMEX market. In conducting surveillance of the NYMEX natural gas market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.[3]

Although the CFTC has issued "special calls" to one electronic trading platform, and that platform has determined to voluntarily provide information on traders' large positions,[4] the CFTC's large trader reporting surveillance system does not routinely reach traders' large OTC positions.[5] Despite the links between prices for the NYMEX futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large

[3] *See* letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.

[4] *Id,* at 7. The CFTC presumably issued this call for information under Section 2(h) (5) of the Act.

[5] As explained in greater detail below, special calls are generally considered to be extraordinary, rather than routine, requirements. Although special calls may be an important complement to routine reporting requirements in conducting market surveillance, they are not a substitute for a comprehensive large trader reporting system.

and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected until after the damage has been done to the market, ultimately harming the consumers or producers of natural gas.

Amaranth Advisors LLC

Last year's implosion of Amaranth Advisors LLC ("Amaranth") and the impact it had upon prices exemplifies these linkages and the impact they can have on natural gas supply contracts for LDCs. Amaranth was a hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances. Amaranth's strategy was reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas.

As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund—MotherRock— further contributed to the extreme volatility in the price of natural gas. The Report by the Senate Permanent Subcommittee on Investigations affirmed that “Amaranth’s massive trading distorted natural gas prices and increased price volatility.”[6]

The lack of OTC transparency and extreme price swings surrounding the collapse of Amaranth have caused bona fide hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

Greater Transparency Needed

APGA members, and the customers served by them, do not believe there is an adequate level of market transparency under the current system. This lack of transparency leads to a growing lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one segment of the total market. Without comprehensive large trader position reporting, the government is currently handicapped in its ability to detect

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[6] *See* PSI Report at p. 119

and deter market misconduct. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on NYMEX, on an OTC multi-lateral electronic trading facility which is exempt from regulation or through bi-lateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms. The passage of legislation is necessary to achieve this needed level of transparency.

Bi-lateral trading

Because Amaranth's trading was largely conducted on both a regulated futures exchange and on an unregulated electronic trading facility, the immediate focus has been confined to the relative inequality of transparency between those two multi-lateral trading venues. Moreover, because the volume of transactions in bi-lateral markets may not be as apparent as the volume of transactions on exchanges or electronic trading facilities there may be a tendency to discount the impact that the bi-lateral markets have upon the price discovery process. APGA believes that, to be comprehensive, a large trader reporting system must include large positions amassed through the OTC bi-lateral markets in addition to those accumulated on futures exchanges or on OTC electronic trading facilities.

Bi-lateral trading can also take place on an electronic trading venue that may be as attractive to traders as multi-lateral trading facilities. Enron On-line, for example, was an all-electronic, bi-lateral trading platform. Using this platform, Enron offered to buy or sell contracts as the universal counterparty to all other traders. On the Enron On-line trading platform, only one participant--Enron--had the ability to accept bids and offers of the multiple participants--its customers-- on the trading platform. This one-to-many model constitutes a dealer's market and is a form of bi-lateral trading.[7]

Section1a(33) of the Act further defines bi-lateral trading by providing that, "the term 'trading facility' does not include (i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary automated trade matching and execution algorithm. . . . ." This means that it is also possible to design an electronic platform for bi-lateral trading whereby multiple parties display their bids and offers which are open to acceptance by multiple parties, so long as the consummation of the transaction is not made automatically by a matching engine.

[7] This stands in contrast to a many-to-many model which is recognized as a multi-lateral trading venue. This understanding is reflected in section 1a (33) of the Act, which defines "Trading Facility" as a "group of persons that . . . provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system."

Both of these examples of bi-lateral electronic trading platforms might very well qualify for exemption under the current language of sections 2(g) and 2(h)(1) of the Commodity Exchange Act. It is entirely foreseeable that if a CFTC large-trader reporting regime were expanded to require the reporting of positions entered into only on multi-lateral electronic trading facilities and does not include bi-lateral electronic trading platforms too, traders who wish to evade the new reporting requirement would simply be able to move their trading activities from an electronic trading facility to a bi-lateral electronic trading platform, just as Amaranth moved its trading from NYMEX to ICE.

Moreover, even in the absence of electronic trading, the ability of traders to affect prices in the natural gas markets through direct or voice-brokered bi-lateral trading should not be underestimated. For example, a large hedge fund may trade bi-laterally with a number of counterparty/dealers using standard ISDA documentation. By using multiple counterparties over an extended period of time, it would be possible for the hedge fund to establish very large positions with each of the dealer/counterparties. Each dealer in turn would enter into transactions on NYMEX to offset the risk arising from the bi-lateral transactions into which it has entered with the hedge fund. In this way, the hedge fund's total position would come to be reflected in the futures market.

Thus, a prolonged wave of buying by a hedge fund, even through bi-lateral direct or voice-brokered OTC transactions, can be translated into upward price pressure on the futures exchange. As futures settlement approaches, the hedge fund's bi-lateral purchases with multiple dealer/counterparties would maintain or increase upward pressure on prices. By spreading its trading through multiple counterparties, the hedge fund's purchases would attract little attention and escape detection by either NYMEX or the CFTC. In the absence of routine large-trader reporting of bi-lateral transactions, the CFTC will only see the various dealers' exchange positions and have no way of tying them back to purchases by a single trader.

Need for Legislation

As previously stated in this testimony, establishing the level of transparency that APGA maintains is warranted will require the passage of legislation. There have been a number of bills introduced in the House that directly address market transparency. Those bills include the PUMP Act introduced by Chairman Stupak, the Market TRUST Act introduced by Congressmen Barrow (D-GA) and Graves (R-MO) and the Close the Enron Loophole Act introduced by Congressman Welch (D-VT). The CFTC has also recommended changes to the Act that would extend its large trading reporting system and other regulatory requirements to contracts traded on an ECM that are significant price discovery contracts.[8]

APGA believes that the legislation that Congress enacts to enhance transparency in these markets should require that large traders report their positions regardless of whether they are entered into on designated contract markets, on electronic trading facilities, on OTC

[8] "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets," Report of the Commodity Futures Trading Commission, http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-07_ecmreport.pdf (October 2007).

bi-lateral electronic trading platforms, in the voice-brokered OTC markets or in direct bilateral OTC markets. This would treat all trading positions in financial natural gas contracts equally in terms of reporting requirements. Extending large trader reporting to OTC natural gas positions and to positions entered into on electronic trading facilities will provide the CFTC with a complete picture of the natural gas marketplace and ensure that the cop on the beat has the tools necessary to be effective.

Although some have raised concerns about the costs of expanding the large trader reporting system, APGA believes the costs would be reasonable. Insofar as the CFTC's large trader reporting system is already operational, there would be no need to create an entirely new program to collect this information. In addition, large traders, such as those which would be required to report to the CFTC, will likely have automated recordkeeping systems for their own internal risk management purposes that could be adapted for the purpose of reporting positions to the CFTC. APGA believes that the costs of a comprehensive large trader reporting system for natural gas would be reasonable and are far outweighed by the benefits in terms of helping assure consumers that the market price is a reflection of appropriate market forces.

Even if Congress determines to extend the CFTC's routine large trader reporting system only to contracts traded on ECMs, it should take care that the enhanced level of transparency is not drawn too narrowly. In this regard, unlike some of the legislative proposals such as the Market TRUST Act and the Close the Enron Loophole Act which apply broadly to ECMs, the CFTC's legislative recommendations apply only to those specific contracts traded on an ECM that have been found to be a significant price discovery contract. Where some contracts on an ECM are found to be a significant price discovery contract but other, related contracts are not, there is the danger that in response to regulatory inquiries or disciplinary action, a trader would move his positions to the less transparent, less regulated contracts trading on the same trading platform. This is the very course of action that Amaranth followed when, in order to avoid regulatory scrutiny, it liquidated its positions on NYMEX and opened similar positions on ICE. In order to avoid this possibility, APGA urges Congress to extend the CFTC's large trader reporting system to all contracts traded on an ECM for a commodity the prices of which are discovered to a material degree by trading on the ECM. In this way, a trader will not be able to obscure its positions by moving them between contracts, some regulated and others not, which are traded on the same ECM.[9]

CFTC Enforcement Authority

The need to provide the CFTC with additional surveillance tools through legislation does not imply that the CFTC has not been vigilant in pursuing wrongdoers using its current statutory enforcement authorities. In this regard, we note that the CFTC has assessed over $300 million in penalties, and has assessed over $2 billion overall in government settlements relating to abuse of these markets. These actions affirm the CFTC's vigor in pursuing misconduct in these markets. However, while APGA applauds the CFTC's vigorous enforcement efforts to address misconduct with respect to trading in the energy

[9] As part of this authority, the CFTC could determine that particular contracts with de minimus levels of trading would be exempt from the reporting requirement. This would enable the CFTC to exempt particular contracts traded on the ECM that are inactive or too illiquid to be used in this way by a trader with large positions.

markets, it notes that increased coordination between Federal regulators is necessary to provide U.S. consumers with the full measure of protection that Congress has provided.

In this regard, both the CFTC and the Federal Energy Regulatory Commission (FERC) initiated enforcement actions against Amaranth in connection with Amaranth's trading activities in natural gas, alleging that Amaranth had engaged in price manipulation. The CFTC brought a civil enforcement action against Amaranth in the United States District Court for the Southern District of New York. [10] The FERC brought an administrative action, issuing an Order to Show Cause and Notice of Proposed Penalties with respect to Amaranth's trading activities.[11] Significantly, FERC's enforcement action was the first brought by it under the anti-manipulation authority granted to FERC by the Energy Policy Act of 2005, Pub. L. No. 109-58 (2005).

In response to FERC's commencement of its enforcement action, Amaranth argued to the U.S. District Court that its futures trading activities are subject to the exclusive jurisdiction of the CFTC and beyond the jurisdiction of FERC. FERC maintains that its authority to impose penalties upon those who manipulate markets in natural gas applies not only to direct participants in the physical gas markets, but also to entities whose manipulative conduct in the financial markets directly or indirectly impacts the price of FERC-jurisdictional transactions. On September 28, 2007 the American Public Gas Association, American Public Power Association (APPA) and National Rural Electric Cooperative Association (NRECA) jointly filed an amicus memorandum of law with the

[10] See, *U.S. Commodity Futures Trading Commission v. Amaranth Advisors, L.L.C., Amaranth Advisors (Calgary) ULC and Brian Hunter*, No. 07CIV 6682 (SDNY filed July 25, 2007)
[11] *Amaranth Advisors, LLC et al*, Federal Energy Regulatory Commission Docket No. IN07-26-001.

court in support of FERC's authority to bring an enforcement action against Amaranth in connection with Amaranth's futures-related trading activities.

As a group that represents consumers, APGA supported Congress' action in providing FERC with its new anti-manipulation authority in the Energy Policy Act of 2005. APGA's view was then, and remains, that the anti-manipulation authority granted to FERC affords consumers an important additional measure of protection. Accordingly, APGA urges the CFTC and FERC to work closely together towards exercising their respective authorities in a way that increases the protection of energy consumers from market abuses, as we believe, Congress intended.

In any event, it must be borne in mind that although these efforts to punish those that manipulate or otherwise abuse markets are important, catching and punishing those that manipulate markets after a manipulation has occurred is not an indication that the system is working. To the contrary, by the time these cases are discovered using the tools currently available to government regulators, our members, and their customers, have already suffered the consequences of those abuses in terms of higher natural gas prices. Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas will provide the CFTC with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

Finally, APGA believes that greater public involvement would assist the CFTC as its policies necessarily evolve to meet the challenge of these new conditions in the energy markets. In this regard, APGA strongly commends the CFTC for its recent announcement of its intention to establish an Advisory Panel on Energy Markets composed of industry experts, including representatives of consumer organizations, to offer technical advice on issues relating to reporting and surveillance of the markets. APGA believes this group will play a valuable role in providing technical advice to the CFTC on issues relating to reporting and surveillance of the markets.

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Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. Without giving the government the tools to detect and deter manipulation, market users and consumers of natural gas who depend on the integrity of the natural gas market cannot have the confidence in those markets that the public deserves.